IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-1474

DOUGLAS P. FIELDS and ALAN E. SANDBERG,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Petitioners Douglas P. Fields and Alan E. Sandberg ask that a writ of certiorari issue to review the judgment of the Court of Appeals for the Second Circuit, entered on September 14, 1978, as corrected by order dated February 14, 1979.

Opinions Below

The majority opinion of the Court of Appeals (Feinberg and Timbers, JJ.), as corrected, and the concurring opinion of the Court of Appeals (Mansfield, J.), are not yet officially reported. They appear as Appendix C to this petition. The opinion of the United States District Court for the Southern District of New York (Haight, J.), not officially reported, appears as Appendix A to this petition.

Jurisdiction

The judgment of the Court of Appeals was entered on September 14, 1978. A timely petition for rehearing with suggestion for rehearing *en banc* was filed October 16, 1978. On February 14, 1979, the Court of Appeals amended its original opinion and denied in all other respects the petition for rehearing. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

Questions Presented

The Second Circuit (Timbers, J.) adopted an all-embracing concept of SEC disclosure that is far broader than the expansive definitions of "security" struck down in *Daniels** and *Forman.** The court held that petitioners were required first to surmise that their prior conduct "may well" have violated some provision of law and therefore to disclose such conduct in SEC filings. The panel's rationale would compel a director to anticipate in SEC filings even claims of violation of state law and thus would open the federal courts to ordinary stockholder's derivative suits. Or, as occurred here, a prosecutor barred by the statute of limitations from indicting for alleged violations of section 16(b), the Hobbs Act, the antitrust laws, or other statutes may now indict a corporate officer for his failure to confess the underlying offense in a subsequent SEC filing.

At the same time, the Second Circuit condoned a procedural excess by the SEC staff that has more awesome impact than did the misuse of the SEC stop-order device

* *Int'l. Brotherhood of Teamsters, Chauffeurs, Warehousers, & Helpers of America* v. *Daniels*, 47 U.S.L.W. 4135 (Jan. 16, 1979); *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837 (1975).

halted in *Sloan.** The court below termed "commendable" a now-widespread practice which has permitted the SEC staff to refer scores of cases for criminal prosecution without the Commission approval required by Congress.

Specifically, the questions presented are:

1. Does the *Northway*** definition of "materiality" mean that a corporate officer must disclose a financially *im*material transaction in an SEC filing *because* that transaction "may well" have violated the law—when that transaction was never adjudged to violate the law, when no litigation had been commenced alleging that it violated the law, and when he contends that it does not violate the law?

We submit that the answer is "no" and that the Second Circuit's decision creates bad new law and conflicts with decisions in two other circuits.

2. May the SEC staff routinely disregard statutes and regulations that indisputably require full *Commission* approval for criminal references, on the excuse that delivery of the SEC file to a prosecutor—and even calls to the prosecutor urging that the SEC "really want[s] to get" the defendants—do not constitute a "criminal reference" but are merely "preliminary communications"?

We submit that the answer is "no" and that the Second Circuit's adoption of the SEC's semantic distinction not only is erroneous (and contrary to a stipulation in the trial court), but also presages Orwellian "newspeak."

* *Securities and Exchange Commission* v. *Sloan*, 436 U.S. 103 (1978).

** *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976).

3. Does a federal district court have the supervisory power to dismiss an indictment on account of "ignoble," "deceitful," and "duplicitous" government conduct when there is no longer available to it any other effective remedy for that misconduct?

We submit that the answer is "yes" and that the Second Circuit's contrary holding conflicts with the First Circuit's decision in *Rodman* v. *United States*, 519 F.2d 1058 (1st Cir. 1975).

Statutes and Regulations Involved

The pertinent provisions of the Securities Act of 1933, of the Securities Exchange Act of 1934, of the Code of Federal Regulations, and of the SEC Manual of Administrative Regulations are set out in the statutory addendum ("Add.") annexed hereto.

Statement of the Case

The Facts

Petitioners Fields and Sandberg (and co-petitioner Friedman) were and are officers of TDA Industries, Inc. ("TDA"), a small, highly successful public corporation whose shares are traded over the counter. (A.* 8)

In January 1975, petitioners made a disclosure of facts to the staff of the New York Regional Office of the SEC, and their attorneys commenced discussions expressly seeking a resolution of all ongoing government inquiry into their affairs. As the District Court found, a principal purpose of the discussions—repeatedly voiced by petitioners' counsel—was to ensure that the SEC would not make a

* "A" refers to the Appendix to this petition.

criminal reference to the Justice Department. (A. 10-11, 85-86)

In February 1975, the Commission entered a *formal* order of *private* investigation into the matters disclosed by petitioners. (A. 12) By mid-June, the SEC staff had satisfied itself that petitioners' disclosures were complete and accurate and told their attorneys that it was prepared to proceed to a settlement. Six months later, after lengthy additional negotiations, the SEC concluded what was from its point of view a "superb" civil settlement. (A. 13-23, Tr.* 995-999) The many onerous terms extracted from petitioners included: payment by the defendants of some $585,000; provisions barring petitioner Fields for two years from serving as chief executive officer of TDA and as a director of two corporations, and from voting his TDA stock; and lifetime disbarment of co-petitioner Davis from practice before the SEC—theretofore the mainstay of his legal practice. (A. 12, 21-23)

The SEC was represented in the negotiations by two staff attorneys, Tucker and Perlmutter. Both were acutely aware of petitioners' oft-expressed objective of concluding a comprehensive settlement that would ensure no criminal reference. Indeed, they affirmatively represented to a lawyer for a prospective TDA director that there would be no criminal reference—and that representation was in turn communicated to petitioner Fields. (A. 12, 17-18, 31, 88)

Yet, in what was found to be a "calculated and deliberate" effort to "deceive" petitioners and safeguard the "superb" civil settlement they were negotiating, the SEC staff concealed (a) that they would not forbear from referring the matter, and (b) that the staff *already* had referred it for criminal prosecution. (A. 35-36)

* "Tr." refers to the transcript of the hearing conducted by the District Court, part of the record on appeal.

In the Fall of 1975, while actively negotiating with petitioners' attorneys—and without any authorization from the Commission, its General Counsel, or the Director of its Division of Enforcement, as required by law—the staff not only repeatedly called the United States Attorney about the case, but also actively recommended prosecution, urging "*we really want to get* [*the defendants*]" (A. 19; emphasis added).

When the SEC settlement was agreed to in principle, but before it was signed, Tucker and Perlmutter continued actively to encourage a criminal prosecution—still without Commission authorization. They called the prosecutor and sent him the SEC's pleadings. (A. 20)

But at the same time, the SEC staff members, afraid they would jeopardize petitioners' final consent, carefully cautioned the prosecutor to stay his hand until the staff concluded the settlement—even though the staff recognized that there was a "statute of limitations problem" (A. 19-20, Tr. 1333).

After the settlement, in early 1976, in plain violation of SEC regulations, the staff sent the SEC "private" investigative file to the U.S. Attorney. (Some fourteen months later, in the middle of the eleven-day hearing in the District Court, the government tried to cure the latter violation by obtaining a *nunc pro tunc* order of the Commission "authorizing" that earlier delivery of the file. (A. 20-21, Tr. 8, 793-95))

Ten months after the SEC settlement was concluded, on *November 8, 1976,* the government filed a twelve-count indictment against petitioners. (A. 3-4, 81-82)

The underlying wrongdoing alleged in the indictment included what the Second Circuit called the "ERD kick-

backs."* Briefly, the ERD transactions were two sales of TDA letter stock in *April* and *May, 1971,* by fourteen TDA stockholders. The indictment alleges that petitioners engineered the sales to a third party, who in turn sold the stock at a profit of $435,000. Petitioners, it is alleged, were to receive 70% of this profit. (A. 4-6, 76-77)

When the grand jury handed up the indictment on *November 8, 1976,* the alleged crime of committing the ERD "kickbacks" was time-barred. In order to indict, therefore, the prosecutor was forced to strain to find a means by which to circumvent the five-year limitations bar. Hence, the indictment alleges not the offense of committing the substantive transactions themselves, but a securities law violation—of failing to disclose the ERD transactions in a November 10, 1971 *TDA* prospectus prepared in connection with a public offering of its stock, and in a proxy statement mailed to *TDA* shareholders in December, 1971.** (A. 4-6, 49-50)

Proceedings Below

The District Court

Petitioners moved to dismiss the indictment on the grounds

a) that it had been procured in breach of an agreement not to criminally refer the matter to the Justice Department

* The Second Circuit's opinion dealt briefly with non-disclosure of another transaction, the so-called "Westcalind kickbacks" (A. 103). If this Court grants plenary review, we shall show that the panel's decision as to that "non-disclosure" also was erroneous.

The indictment contains various additional charges against various petitioners that are not directly involved in this Court, except to the extent that petitioners challenge substantially the entire indictment as the product of government misconduct.

** Specifically, the indictment charges conspiracy (18 U.S.C. § 371) and violations of the criminal provisions of the Securities Act of 1933 (15 U.S.C. § 77q(a)) and of the Securities Exchange Act of 1934 (15 U.S.C. § 78n(a)).

and that the governmer : fraudulently had led petitioners to believe that no such referral had taken place;

b) that, irrespective of the agreement, the government's misconduct was so egregious as to call for dismissal under the court's supervisory powers; and

c) that the criminal reference and recommendations for prosecution violated the SEC's own rules and regulations.

Alternatively, petitioners argued, the indictment failed to allege a crime under the securities laws.

The District Court (Haight, J.) held an eleven-day hearing, and on June 2, 1977, in an 82-page memorandum opinion and order, granted the bulk of petitioners' motion by striking substantial portions of the indictment. (A. 1-74)

Judge Haight's central finding was that the government, acting through its representatives at the SEC, had "played an ignoble part" in leading petitioners to believe there would be no criminal reference, and in concealing the fact that a reference already had been made. After a painstaking review of the facts, he found the conduct of the SEC staff "fraudulent," "misleading," "calculating and deliberate," "deplorable," and "wrongful"* (A. 21, 34, 36).

On the issue of remedy, Judge Haight carefully analyzed the alternatives still available to him and concluded that any remedy short of dismissal of the tainted portions of the indictment would be ineffectual** and inconsistent with

* Although Judge Haight declined to hold that there had been an *express* agreement not to criminally refer this case, he did find that the SEC "affirmatively indicated that there would be no criminal reference" (A. 32).

** The parties clearly could not be placed in the *status quo ante* by reopening the SEC "civil" settlement. For example, it would have been impossible to reverse the sanction which barred petitioner Fields from voting his stock or serving as an officer or director of TDA—that "sentence" already had been substantially served.

safeguarding judicial integrity. In so holding, he relied on the closely analogous decision of the First Circuit in *Rodman* v. *United States,* 519 F.2d 1058 (1st Cir. 1975), where an indictment was dismissed on account of SEC staff misconduct in recommending criminal prosecution. (A. 41)

The District Court also sustained certain of the petitioners' alternate grounds for dismissal. Analyzing the purpose of the November 1971 TDA prospectus, the court held that the ERD transactions were simply immaterial to the public's purchase of TDA stock pursuant to that prospectus. The government, said the court, could not show how those earlier transactions reflected upon the company's financial status or otherwise. (A. 48-50)

As to the December 1971 TDA proxy statement, the court held that the ERD transactions bore no direct relationship to the business of the prospective annual meeting—no "transaction causation" could be demonstrated. (A. 53)

Finally on the issue of the validity of the criminal reference, the Chief of the U.S. Attorney's Fraud Unit had testified that he "could not remember" a case in two years in which the procedures set forth in the statutes and SEC regulations for criminal references had actually been followed. (A. 21) The District Court, however, declined to upset that now-endemic "informal" system of criminal references made without Commission approval, apparently on the view (later acknowledged by the SEC to be erroneous) that the Commission had sanctioned "informal" references by the staff that have no Commission authorization. (A. 33)

The Court of Appeals

After the government appealed, the Second Circuit requested that the SEC submit an *amicus* brief on the ques-

tion of the validity of the criminal reference made by the SEC staff.

On that issue, Judge Timbers, writing for a majority of the panel, reasoned as follows:

In the case of a formal, private SEC investigation following a Commission *formal* order of investigation, the pertinent statute and regulations do require explicit Commission authorization for a *formal* criminal reference. In the case of an *informal* SEC investigation, the regulations permit the staff to make an *informal* criminal reference without explicit Commission authorization. He purported to find authority for this distinction in a delegation of authority to the staff set forth in passages from an SEC internal manual set out in footnotes to the opinion.* (A. 90-94)

Judge Timbers then stated (contrary to fact, as the court later acknowleged) that the SEC investigation in this case was an *informal* investigation. Since, as he further opined, the SEC staff's delivery of the file—and recommendations of criminal prosecution—were merely an *informal* criminal reference, he held that the reference procedure here employed did not require express Commission approval. Therefore, he reasoned, it was lawful**. (A. 93-94)

Judge Timbers went on to praise the pervasive "informal" criminal reference procedure that had developed between the SEC staff and the U.S. Attorney's Office. Far

* In fact, there is no authority for such a distinction: the SEC internal manual was not "published," and the statute requires that any such delegation be by "published" rule (Add. 3). Moreover, the passages from that manual that immediately follow those quoted in the opinion contain an express proviso excluding such delegation in the case of formal investigations (Add. 7-8).

** In fact, it is now undisputed that even *informal* criminal references require Commission approval. *See infra,* pp. 12-13.

from being unlawful, he said, it was "a commendable example of inter-agency cooperation" (A. 95).

Turning to the issue of the SEC staff's fraudulent conduct, the panel held that the District Court abused its discretion in dismissing the tainted portions of the indictment on account of that misconduct. The majority, although not disturbing any of Judge Haight's findings, ruled that the remedy of dismissal was not warranted because a) the misconduct here was not as "egregious" as that in *Rodman v. United States, supra,* and b) the deception practiced upon petitioners did not "prejudice" them in the criminal case.* (A. 97-98)

The majority then addressed the district court's alternate grounds for dismissing substantial portions of the indictment. Adopting almost *in haec verba* a new theory of materiality first advanced by the government in the Court of Appeals, Judge Timbers reasoned as follows: The *April and May 1971* ERD transactions were "material" to TDA, and thus were required to be disclosed in the *November 1971 TDA* prospectus, because those asserted "kickbacks" to petitioners

> "*may well* be immediately recoverable by TDA, Inc. as a short swing purchase and sale under Section 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1976)" (A. 102; emphasis added).

(Not even the SEC had claimed in its civil investigation that the alleged ERD "kickbacks" constituted a 16(b) violation.)

The panel adopted a similar rationale to find the ERD transactions "material" to the TDA December 1971 proxy

* Judge Mansfield, in a brief concurring opinion, found the SEC's conduct "deceitful and duplicitous," but he nevertheless concurred in the result because he believed that "no prejudice warranting dismissal of the indictment is shown" (A. 105).

statement. The panel noted first that one of the proxy rules requires disclosure of

> 'indebted[ness] to the issuer . . . [of e]ach director or officer of the issuer . . . [including] any indebtedness . . . [which] arose under Section 16(b) of the [Securities Exchange] Act . . .' (A. 103).

It thereupon reasoned:

> "Defendants' sale of TDA shareholders' lettered stock immediately after acquiring it in a private placement—the ERD kickbacks—clearly would violate Section 16(b). Accordingly, their failure to disclose these kickbacks, if proven, would constitute a violation of Item 7(e)(4) and consequently of Section 14(a)" (A. 103-04).

The Court of Appeals remanded the case with instructions to reinstate the entire indictment. (A. 104)

Rehearing

On petitioners' motion for rehearing, the SEC filed still another *amicus* brief. In that brief, the SEC conceded

a) that the investigation here was a "formal" investigation;

b) that *both* "formal" and "informal" criminal references require approval by the Commission itself;

c) that there was no Commission approval in this case.

On February 14, 1979, the Court denied the petition for rehearing, but adopted *in toto* the position of the SEC in its *amicus* brief. The Court made certain "technical" corrections to its opinion suggested by the SEC, and adopted the SEC position that the staff's conduct here was not a "criminal reference" at all—but amounted merely to "preliminary communications" (A. 109-11).

But neither the amended opinion nor the SEC brief so much as mentioned the fact that the government had *stipulated* in the District Court that the SEC staff here ***had made a "criminal reference"***—and that the parties and the court proceeded on that basis through eleven days of hearings. (Tr. 7-9; A. 20-21, 23)*

Reasons for Granting the Writ

I.

The Second Circuit's Unwarranted, Ominous Expansion of SEC Disclosure Laws Creates a Conflict Among the Circuits.

The Second Circuit committed serious error in its interpretation of the scope of the federal securities laws—error with far-reaching implications for the civil and criminal administration of those laws and error which creates conflict among the circuits.

The Panel's Far-Reaching Error

The Second Circuit panel created a bootstrap definition of "materiality" that required petitioners (a) to draw a legal conclusion they dispute and then, on that basis alone, (b) to "disclose" that legal conclusion, or the facts forming the basis for that conclusion, in SEC filings.

The panel, purporting to rely on this Court's definition of "materiality" in *Northway,*** held that the April and May 1971 ERD transactions were "material" *to TDA* so

* Petitioners had brought this stipulation to the Court of Appeals' attention long before it corrected its opinion.

** *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976).

as to require disclosure in its November 1971 prospectus because:

> Defendants' $300,000 profit on this transaction, while ultimately coming out of the pockets of the defrauded stockholders, *may well* be immediately recoverable by TDA, Inc. as a short swing purchase and sale under Section 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1976) (A. 102; emphasis added).

Similarly, with respect to TDA's December 1971 proxy statement, the panel found omission of the ERD "kickbacks" material because the proxy rules require disclosure of an officer's 16(b) "indebtedness" to the issuer. (A. 102-03)

But petitioners dispute as a matter of law that 16(b) even applies to the ERD transactions—much less that they incurred any 16(b) liability, or "indebtedness" to TDA. At the time the 1971 TDA prospectus and proxy statements were filed, no litigation had been commenced asserting that petitioners had committed a 16(b) violation; indeed, to this day, there has been no such litigation (other than the government's *de novo* appellate criminal theory). Even the SEC in its lengthy civil complaint against petitioners made no such claim.

The panel's definition of "material" therefore comes to this: Facts concerning corporate-related conduct by a corporate officer, whether or not significant in a financial sense,* are "material" and are required to be disclosed, if those facts "may well" someday be found by some court to constitute some violation of law—even if, at the time of the pertinent SEC filing, that conduct had never been adjudged or alleged to constitute a violation and even if the officer maintains it constitutes no violation.

As one court put it, "It would be an interesting theory indeed to impose upon a corporation the duty to disclose . . . not yet existent litigation," *Shapiro* v. *Belmont Industries, Inc.*, 438 F. Supp. 284, 292 (E.D. Pa. 1977).

Unfortunately, the Second Circuit here adopted just that "interesting theory" of the disclosure laws. That theory must be wrong.

First, *Northway* made it clear that even *facts* which a reasonable investor "might" consider important are not material because the "might" formulation is "too suggestive of mere possibility." *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976). The panel's formulation here—"may well"—is no more concrete. Indeed, the panel's interpretation of "materiality" would have a corporate officer engage in *two* levels of conjecture—speculating first whether his conduct "might" have violated 16(b) or some other provision of law, and second, whether a reasonable investor "might" find the purported illegal action significant to an investment decision.

Further, in looking to the possible "materiality" of legal conclusions rather than facts, the panel's entire focus is

* The amount involved in the ERD transactions was clearly not "material" to TDA in any recognized financial sense. TDA's assets in 1971 exceeded $18,000,000. *See* Joint Appendix in the Court of Appeals at 135. The speculative potential asset of $300,000 that the panel held "may well" be recoverable constituted 1.6% of TDA's assets. We know of no case or other authority which suggests that such a miniscule percentage of even *hard* assets is material, much less

(footnote continued on following page)

that such a contingent pre-tax asset is material. (Under generally accepted accounting principles—indeed, the SEC itself insists that—a corporation's recovery under 16(b) is not an income item but a balance sheet item. *See, e.g.*, L. Rappaport, SEC Accounting Practice and Procedure 18.21 (3d Ed. 1972); Montgomery's Auditing 621 (9th Ed. 1975).

In any event, it is clear from the panel's holding as to the proxy statement that the panel was not relying on financial materiality.

wrong. And the panel suggests no limit on the extent to which directors and officers are to divine and disclose the possible—perhaps, remotely conceivable—legal consequences of their actions, upon pain of damage suits or, as here, criminal penalties.

The consequences of the panel's decision for both the civil and criminal administration of the securities laws are portentous.

On the civil side, the panel's rationale threatens to "jigsaw every kind of corporate dispute into the federal courts through the securities acts as they are presently written,"* and to undermine this Court's efforts to disengage the federal judiciary from such disputes.** The plaintiff in the garden-variety derivative suit asserting claims on behalf of the corporation against a director now may obtain federal jurisdiction simply by alleging, in the words of the Second Circuit panel, that the directors failed to disclose in some SEC filing that the corporation "may well immediately recove[r]" for the director's alleged waste, breach of fiduciary duty, or other common law offense.

As to the criminal laws, the panel's decision would make the securities laws an alternative enforcement arm for the entire federal criminal code.

In the panel's word, petitioner's alleged violations here were "kickbacks"—acts which are offenses under the Hobbs Act or the mail fraud provisions. *See, e.g., United States* v. *Phillips,* 577 F.2d 495 (9th Cir. 1978), *cert. denied,* 99 S.

* Cary, *Federalism and the Corporate Law: Reflections Upon Delaware,* 83 YALE L.J. 663, 700 (1974).

** *See, e.g., Green* v. *Santa Fe Industries,* 430 U.S. 462 (1977); *Cort* v. *Ash,* 422 U.S. 66 (1975).

Ct. 154 (1978); *United States* v. *Rabbitt,* 583 F.2d 1014 (8th Cir. 1978).*

But by the time the indictment here was filed—after a delay caused in part by the government's own misconduct in urging prosecutorial delay until the SEC settlement was concluded—the five-year statute on the Hobbs Act or for mail fraud had run. So the prosecutor indicted petitioners for failure to "disclose" that they had committed the underlying offense.

The opinion on which the Second Circuit upheld that indictment, if applied according to its rationale—*i.e.,* there exists a duty to disclose conduct which "may well" have violated the law—would enable a prosecutor to embrace *any* corporate-related federal crime within a securities law disclosure violation. The federal statute of limitations, as applied to corporate executives, would no longer be five years, but an indefinite period extending throughout the executives' tenure as an officer having SEC filing responsibilities. The statute would not even begin to run from the date of the underlying offense—but from the date of the officer's *last* SEC filing.

The Second Circuit's interpretation of the disclosure laws is far too invasive: the panel in effect viewed SEC filings as corporate officers' confessionals—contrary to our most basic notions about self-incrimination. Whether the issue be "materiality" or some other concept, it surely cannot become the law of this nation that an officer is required to advertise in a public filing something he did in the past because it "may well" have violated some law—and if he

* Or, as the District Court noted, those alleged "kickbacks" might constitute 10b-5 violations *vis-a-vis* the selling stockholders. But, as he correctly observed, any such violation "would [also] appear to be barred by the statute of limitations" (A. 49).

fails so to advertise, he can be indicted for the nondisclosure when he could not be indicted for the underlying substantive crime.

We respectfully submit that a decision having such impact upon the civil and criminal law should be reviewed by this Court.

The Conflict

Review is necessary, too, because—not surprisingly—the Second Circuit's bootstrap view of the securities laws as requiring disclosure of speculative conclusions is in conflict with decisions in other circuits—indeed, with decisions in the same circuit.

The Third Circuit has held that there is no requirement to disclose that corporate conduct may be *ultra vires. Ash* v. *LFE Corp.,* 525 F.2d 215 (3d Cir. 1975). The Eighth Circuit has held that there is no requirement to "characterize the bonus aspect of the transaction as plaintiff would have it characterized." *Golub* v. *PPD Corp.,* 576 F.2d 759, 765 (8th Cir. 1978).

See also Browning Debenture Holders' Committee v. *DASA Corp.,* 560 F.2d 1078, 1084 (2d Cir. 1977) (no requirement to disclose that corporate conduct may be a violation of state law); *Shapiro* v. *Belmont Industries, Inc.,* 438 F. Supp. 284 (E.D. Pa. 1977); *Freedman* v. *Barrow,* 427 F. Supp. 1129, 1144 (S.D.N.Y. 1976) ("Failure to disclose a legal theory with which those soliciting [proxies] do not agree . . . does not violate" federal disclosure laws); *Robbins* v. *Banner Industries, Inc.,* 285 F. Supp. 758, 762 (S.D.N.Y. 1966) (No requirement to disclose allegedly "fraudulent activity.")

II.

The Court Below Erred in Upholding the SEC Staff's Widespread Abuse of the SEC's Published Rules on Criminal References.

The SEC's latest annual report reveals a recent dramatic increase in the number of criminal referrals to the Justice Department.* At the same time, the lower courts increasingly have been faced with problems arising out of the SEC's exercise of prosecutorial power, particularly in the context of settlement negotiations. *See e.g., Rodman* v. *United States,* 519 F.2d 1058 (1st Cir. 1975); *United States* v. *Merz,* 580 F.2d 342 (8th Cir. 1978); *United States* v. *Minnesota Mining & Manufacturing Co.,* 551 F.2d 1106 (8th Cir. 1977); *United States* v. *Bloom,* 450 F. Supp. 323 (E.D. Pa. 1978); *United States* v. *Dondich,* 460 F. Supp. 849 (N.D. Cal. 1978).

In these circumstances, this Court should review a decision below which is flagrantly erroneous and which sanctions a pervasive disregard of the statutes and regulations on criminal references.

The securities statutes each contain a provision authorizing the *Commission* to transmit evidence concerning alleged violations of law to the Attorney General for criminal prosecution (Add. 2-3).** The language of each statute provides that "[T]he *Commission* may transmit such evidence . . ." *See* 15 U.S.C. § 77(t) (1976); 15 U.S.C. § 78u (1976) (emphasis added). The use of the permissive

* There were 100 such referrals in 1977 and 116 in 1976; in 1968-71 the number ranged from 22 to 40. 43 SEC ANN. REP. 326 (1977).

** "Commission" is defined to mean the five commissioners. 17 C.F.R. § 200.10 (1978).

"may" gives the Commission the option to make a reference or not; it does not render the form of reference optional.

To be sure, the statutes grant the Commission authority to delegate this responsibility to an employee of the Commission by "published rule or order." 15 U.S.C. § 78d-1(a) (1976) No published rule or order, however, makes any such delegation.

Indeed, not only must every SEC criminal reference have Commission approval, but, recognizing that the power to recommend prosecution is awesome, the Commission regulations require staff review at the highest level:

> ". . . [T]he Director [of the Division of Enforcement] is responsible, in collaboration with the General Counsel, for the review of cases to be referred to the Department of Justice with a recommendation for criminal prosecution." 17 C.F.R. § 200.19(b) (1978)

In this case, there was no Commission approval nor any consultation with the SEC's General Counsel or Director of Division of Enforcement. The Director of the Division of Enforcement testified that before the reference he had never even heard of this case. (Tr. 674) The two SEC staff members here neither informed nor consulted anyone of authority before making what was *stipulated* to be a criminal reference. (Tr. 9)

Initially, the Second Circuit avoided the inevitable conclusion that this reference was unlawful only by a) adopting a factually incorrect premise that the SEC had here conducted only an "informal" investigation, and b) by characterizing the reference as an "informal" reference that thereby somehow made it lawful. Even that distinction was error: nothing in any published rule or regulation permits even "informal" criminal references without Commission approval, as the SEC conceded in its last *amicus* brief.

The panel then compounded its error when it "corrected" its opinion and said, at the SEC's urging, that the reference here was lawful because it wasn't a reference at all—merely "preliminary communications."

We most respectfully submit that such a semantic distinction would be absurd under the facts of this case (which included a call to the prosecutor saying "we want to get" petitioners)—even if there had been no stipulation in the trial court that what occurred *was* a "criminal reference." Given that stipulation, the decision of the panel on this point is utterly indefensible.

In short, the SEC violated its own rules in referring this case for criminal prosecution. And the only appropriate remedy was to void the fruits of that misconduct—in this case, to dismiss the indictment.*

The violation is not an isolated instance. The trial court found that by their "informal" reference, the two SEC staff members here had "followed a practice which had grown up over the past several years" and which in fact "accounts for the majority of present-day criminal references in the Second Circuit" (A. 20-21, 34). *See also United States* v. *Bloom, supra,* 450 F. Supp. at 329. It appears, in short, that the abuse of the SEC's published regulations on criminal references is becoming universal. The Second Circuit, terming that abuse "commendable," clearly will not compel the agency to abide by its rules.

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* This Court has long recognized the need for regularity and accountability in the administrative process, and has held repeatedly that administrative agencies must scrupulously adhere to the standards they have established for their own conduct. *Yellin* v. *United States,* 374 U.S. 109 (1963); *Vitarelli* v. *Seaton,* 359 U.S. 535 (1959); *Service* v. *Dulles,* 354 U.S. 363 (1957); *United States ex rel. Accardi* v. *Shaughnessey,* 347 U.S. 260 (1954). If an agency deviates from its rules and regulations, any action so taken is void. *Yellin* v. *United States, supra.*

This Court, we submit, should issue the writ in order to do so—and in order to correct the panel's error in reinstating the indictment.

III.

The Decision Below Conflicts With the First Circuit and Unduly Restricts the Supervisory Power of the District Courts to Deal With Government Misconduct.

The Second Circuit held that the District Court was powerless to deal effectively with "the deceitful and duplicitous" conduct of the SEC staff members here. Its unduly narrow construction of the supervisory power stands in stark contrast with that of the Court of Appeals for the First Circuit in *Rodman* v. *United States,* 519 F.2d 1058 (1st Cir. 1975).

In *Rodman,* the First Circuit held that it was not an abuse of discretion for a district court to dismiss an indictment in the interests of the integrity of the judicial process and fairness—where the district court found that the SEC breached an agreement to recommend against criminal prosecution.

The panel in this case sought to distinguish *Rodman* by saying (a) that since *Rodman* involved an express agreement between the SEC staff and defendant, the misconduct in that case was more "egregious;" and (b) that the defendant in *Rodman* was prejudiced by the fact that he had given incriminating evidence in reliance on the agreement.

These distinctions are untenable—and the two cases are hopelessly in conflict.

As to the panel's first purported ground of distinction, it is difficult to comprehend how even as an abstract matter it is morally or legally more "egregious" for the government merely to breach a contract (as in *Rodman*) than fraudulently to induce a contract (as was the case here)— or why the former warrants a broader remedy than the latter. The law has always treated fraud as more reprehensible than breach of contract and has afforded the victim of a fraud broader remedies than the victim of a breach of contract.

Indeed, the facts in *Rodman* were that the SEC staff failed to keep its word because it believed (erroneously, but apparently in good faith) that the defendant had ceased his cooperation and thus failed to meet *his* end of the bargain. 519 F.2d at 1059. There was no finding in *Rodman* of fraud or bad faith on the part of the government. Surely the fraudulent conduct here was more "egregious" than the breach in *Rodman.*

Second, the panel was even more clearly in error when it attempted to distinguish *Rodman* on the ground that Mr. Rodman suffered prejudice in his criminal case, while the petitioners here allegedly did not. The asserted prejudice in *Rodman* was the incriminating testimony given by the defendant to the SEC. But the government had stipulated not to use that testimony in its prosecution of Mr. Rodman. Thus, there was no prejudice to Mr. Rodman—and neither the district judge nor the First Circuit relied upon any showing of prejudice. Nevertheless, the District Court held, and the First Circuit agreed, that dismissal of the indictment was required—out of "fairness".* The same principles of fairness apply here. And the very same grounds existed for the District Court's application of his supervisory power.

The writ should issue to resolve this conflict in the circuits.

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* Joint Appendix in the Court of Appeals, at 165 (quoting from the unreported opinion of the Massachusetts District Court).

As between the conflicting views of the two circuits, the Second Circuit's is far too narrow a reading of the supervisory power. Justice Frankfurter observed:

> Insofar as they are used as instrumentalities in the administration of criminal justice, the federal courts have an obligation to set their faces against enforcement of the law by lawless means or means that violate rationally vindicated standards of justice, and to refuse to sustain such methods by effectuating them. They do this in the exercise of a recognized jurisdiction to formulate and apply 'proper standards for the enforcement of the federal criminal law in the federal courts.' *Sherman* v. *United States,* 356 U.S. 369, 380 (1958) (Frankfurter, J. concurring).

And so, where government misconduct is substantial, courts have not hesitated to dismiss an indictment—in the interest of maintaining the integrity of their own processes. *See Dixon* v. *District of Columbia,* 394 F.2d 996, 970 (D.C. Cir. 1968) ("I do not believe we are foreclosed from granting immunity from prosecution in order to deter blatant Government misconduct"); *United States* v. *McLeod,* 385 F.2d 734 (5th Cir. 1967); *United States* v. *Paiva,* 294 F. Supp. 742, 746 (D.D.C. 1969). ("Courts can no more be made the tools of improper administrative conduct than they can become the enforcers of odious agreements").

The Second Circuit panel held that a demonstration of prejudice is necessary before a federal court will intercede to rectify blatant government misconduct.* But that view

* Petitioners, of course, *were* severely prejudiced by the misconduct. Not only was the filing of the indictment itself a very real form of prejudice, but petitioners were deprived of a significant negotiating opportunity—*i.e.*, petitioners could have bargained with the United States Attorney for the sanctions contained in the "civil" settlement. Once petitioners agreed to the SEC settlement, those sanctions were lost to them for any negotiation with the U.S. Attorney.

is inconsistent with the very rationale underlying application of the supervisory power:

> "So long as the 'error' violates the Court's standards for conducting judicial proceedings, reversal will usually follow *even though the effect on the particular litigant may have been inconsequential or non-existent*". Note, *The Supervisory Power of the Federal Courts,* 75 HARV. L. REV. 1656, 1657 (1963) (Emphasis added)

The panel's decision simply ignores what both the decisions of this Court and the scholarly literature have recognized—that the supervisory power is an important and malleable tool in the administration of justice more concerned with the integrity of the judicial process than with whether the misconduct has prejudiced a litigant. *See, e.g., Santobello* v. *New York,* 404 U.S. 257 (1971); Note, *The Judge-Made Supervisory Power of the Federal Courts,* 53 GEO. L.J. 1050 (1965); Note, *Supervisory Power in the United States Courts of Appeals,* 63 CORN. L. REV. 642 (1978); Hill, *The Bill of Rights and the Supervisory Power,* 69 COLUM. L. REV. 181 (1969).

This Court should grant the writ to provide guidance to inferior federal courts in the exercise of this important power.

CONCLUSION

SEC Commissioner Karmel, disturbed (like much of the bar and business community*) about increasing SEC in-

* R. Karmel, Jurisdictional Concerns in Securities Law Enforcement (Feb. 23, 1978). (Address Before the Federal Bar Council) at 12; *See also* Interview with SEC Commissioner Roberta Karmel, [1978] SEC REG. & L. REP. (BNA) No. 467 at AA-1; *The SEC: Going Too Far Too Fast,* BUSINESS WEEK, November 27, 1978, at 86; Klein, *A Response on SEC Consents—'Process Is Corrupting All',* LEGAL TIMES OF WASH., June 26, 1978, at 21.

trusion into matters outside its jurisdiction, and *dehors* authorized procedures, recently cautioned:

> "The government should not have the power to prosecute its citizens for behavior which has not been declared illegal by the Legislature. And prosecutorial power should be kept within the confines of specified sanctions and procedures."

Government power in this case was exceeded in both these respects.

We ask this Court to grant *certiorari* to review the Court of Appeals' acquiescence in these excesses, and upon such grant, to vacate the Court of Appeals' reinstatement of the indictment.

March 26, 1979

Respectfully submitted,

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ADDENDUM

Statutes

Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(a) (1976):

> (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Securities Exchange Act of 1934, § 14(a), 15 U.S.C. § 78n(a) (1976):

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title.

Securities Act of 1933, § 20, 15 U.S.C. § 77t (1976):

Injunctions and prosecution of offenses.

(b) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this subchapter, or of any rule or regulation prescribed under authority thereof, it may in its discretion, bring an action in any district court of the United States or United States court of any Territory, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General who may, in his discretion, institute the necessary criminal proceedings under this subchapter.

Securities Exchange Act of 1934, § 21, 15 U.S.C. § 78u (1976):

Investigations; injunctions and prosecution of offenses.

(e) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this chapter, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States or the United States courts of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter.

15 U.S.C. § 78c (1976):

Definitions and application—Definitions.

(15) The term "Commission" means the Securities and Exchange Commission established by section 78d of this title.

* * *

15 U.S.C. § 78d-1 (1976):

Delegation of functions by Commission—Authorization; functions delegable; eligible persons; application of other laws.

(a) In addition to its existing authority, the Securities and Exchange Commission, hereinafter referred to as the "Commission", shall have the authority to delegate, by published order or rule, any of its functions to a division of the Commission, an individual Commissioner, a hearing examiner, or an employee or employee board, including functions with respect to hearing, determining, ordering, certifying, reporting, or otherwise acting as to any work, business, or matter: . . . .

Regulations

17 C.F.R. § 200.10:

The Commission.

The Commission is composed of five members, ... The Commission is assisted by a staff, which includes

lawyers, accountants, engineers, financial security analysts, investigators and examiners, as well as administrative and clerical employees.

17 C.F.R. § 202.5:

Enforcement activities.

(b) Where it appears after investigation or otherwise that there has been a violation of any of the provisions of the acts administered by the Commission or the rules or regulations thereunder, the Commission may take one or more of the following actions: institution of administrative proceedings looking to the imposition of remedial sanctions, initiation of injunction proceedings in the courts, and, in the case of a willful violation, reference of the matter to the Department of Justice for criminal prosecution. The Commission may also on some occasions refer the matter to other Federal agencies, State authorities or organizations such as the stock exchanges or the National Association of Securities Dealers, Inc.

17 C.F.R. § 200.19b:

Director of the Division of Enforcement.

The Director of the Division of Enforcement is responsible to the Commission for the supervision and conduct of all of the enforcement activities under each of the acts administered by the Commission and the investigations relating thereto. The Director is responsible also for the institution of administrative and injunctive actions arising out of such investigations and enforcement activities and for the determination of whether the available evidence supports the allega-

tions in the proposed complaint. In addition, the Director is responsible, in collaboration with the General Counsel, for the review of cases to be referred to the Department of Justice with a recommendation for criminal prosecution.

17 C.F.R. § 200.21:

The General Counsel.

The General Counsel is the chief legal officer of the Commission and is responsible for the representation of the Commission in judicial proceedings in which it is involved as a party or as amicus curiae, directing and supervising all civil litigation in the U.S. District Courts (except District Court proceedings under Chapter X of the Bankruptcy Act), and representing the Commission in all cases in appellate courts. He is responsible, in collaboration with the Division of Enforcement, for review of cases to be referred to the Department of Justice with a recommendation for criminal prosecution.

17 C.F.R. § 230.122:

Nondisclosure of information obtained in the court of examinations and investigations.

Information or documents obtained by officers or employees of the Commission in the course of any examination or investigation pursuant to section 8(e) or 20(a) (48 Stat. 80, 86; 15 U.S.C. 77h(e), 77t(a)) shall, unless made a matter of public record, be deemed confidential. Officers and employees are hereby prohibited from making such confidential information or documents or any other non-public records of the Com-

mission available to anyone other than a member, officer, or employee of the Commission, unless the Commission authorizes the disclosure of such information or the production of such documents as not being contrary to the public interest. Any officer or employee who is served with a subpoena requiring the disclosure of such information or the production of such documents shall appear in court and, unless the authorization described in the preceding sentence shall have been given, shall respectfully decline to disclose the information or produce the documents called for, basing his refusal upon this section. Any officer or employee who is served with such a subpoena shall promptly advise the Commission of the service of such subpoena, the nature of the information or documents sought, and any circumstances which may bear upon the desirability of making available such information or documents.

17 C.F.R. § 240.14a-9 (1978):

> (a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

SEC Manual of Administrative Regulations

Manual Release No. 155-75

1:171.01 9/24/74

Section 171: Cooperation With Federal, State and Foreign Government Authorities and With Self-Regulatory Organizations

171.06

Cooperation With Other Federal Law Enforcement Authorities.

Since Commission cases frequently involve violations of the mail fraud statute and may involve other Federal statutes, the Commission recommends and encourages full cooperation with inspectors of the United States Post Office Department and other Federal law enforcement officials. Commission officials are authorized in their discretion to make information developed in the course of their investigations, other than formal investigations which have been ordered by the Commission, and other non-public information available to these officials and to render such investigative assistance as may be required.

171.07

Furnishing Information to Other State and Federal Law Enforcement Agencies.

In cases not falling within Subsections .05 and .06 of this Section, that is, situations other than referral of a matter for State enforcement action, or cooperation with the Post Office Department or other Federal law

enforcement officials, Commission officials are authorized in their discretion to make available to Federal and State law enforcement to Federal and State law enforcement (sic) agencies information developed in the course of an investigation other than a formal investigation which has been ordered by the Commission and other non-public information when the Commission official is satisfied that such action clearly will not interfere with the Commission's enforcement functions in the particular case or in other cases.

171.08

Disclosure of Information in Formal Investigations.

If a Commission official believes that a formal investigation which has been ordered by the Commission should be referred to Federal or State authorities for enforcement action under the foregoing standards, the Commission official may recommend to the Commission that information be turned over to such authorities.